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FISCAL DEVOLUTION BY FINANCE COMMISSION : PLEA FOR A DYNAMIC APPROACH

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An attempt is made in the present note to outline an approach to the transfer of financial resources from the Centre to States under the aegis of the Finance Commission, primarily based on the following propositions: One, the devolution of financial resources by the Finance Commission needs to be looked as an integral part of the national effort for development carried out by the States rather than a mechanism to resolve issues relating to inter-governmental fiscal relations, involving complaints, bargaining and compromise. Second, it should be used as an effective mechanism for bringing about a reduction in inter-regional disparities in the levels of development among different regions, rather than as a system of rewards, punishment and philanthropy. Third, the criteria for allocation of resources should reflect the needs of the respective states assessed not in the limited and static framework of maintenance of services and budgetary deficit and surplus, but in terms of the strategy set for national development, and efforts needed in different states to implement the accepted scheme of priorities.

Six Finance Commissions have in the past applied themselves to the task of recommending the principles and pattern of distribution between the Union and the States of the net

proceeds of taxes divisible between the two, under Chapter I of Part XII of the Constitution, and grants-in-aid of the revenue to the States out of the Consolidated Fund of India under Article 275 of the Constitution. The basic approach that the Commissions have adopted is that of allocating resources to States on the basis of needs mostly interpreted in a budgetary rather than a planning and development sense. The fact that development planning has come to stay as the mode of managing the economy has been taken note of by them, but in working out the principles and recommendations, this vital aspect does not seem to have received adequate attention. For example, the Sixth Finance Commission emphasised the need for conceiving the distribution of national resources between the Centre and the States in 'dynamic' rather than 'static' terms and thought it "more appropriate to view the problem as one of distribution of available resources as between subjects coming constitutionally within the competence of the Centre and those coming within the purview of the States," rather than as a problem of "redistribution of resources between the Centre and the States."

In its analysis and recommendations, the Sixth Finance Commission, however, fell in the track laid by the earlier

Commissions and did nothing significant to operationalise the above approach. Each of the items under its consideration, distribution of net proceeds of income tax, determination of States' share in Union excise duties and its distribution among them, distribution of additional excise duties, grants in lieu of railway passenger tax, distribution of estate duty and grants-in-aid to States under Article 275 has been treated in isolation and different principles applied in each case. 'Needs' of States in relation to their developmental requirements, might differ by heads of expenditure, and not by articles of Constitution under which the funds are received; and, therefore, there is no room for difference in principles of allocation for different taxes and grants-in-aid, if the basic idea is to provide adequate financial resources for subjects coming within the purview of the States. The distinction between the Plan and non-Plan expenditure has been a matter of controversy, and is held as unrealistic by the Sixth Finance Commission, as by many others. The distinction unfortunately remains and prevents the development of an integrated approach to the problem of distribution of national resources among Centre and States and among different States. Some coordination is sought to be achieved by appointing

one of the members of the Planning Commission on the Finance Commission, yet the attempt at an overall assessment of the States' requirements for their developmental efforts and adequacy of funds from the various sources, is not evident in the work of the Finance Commissions.

Over the period since 1951, the transfer of resources from the Centre to the States has tremendously increased. The transfers are effected through the mechanism of Finance Commission, Planning Commission and 'other transfers', and the importance of the three mechanism has been more or less equal. In recent years, the transfer through Finance Commission has been larger than those through the Planning Commission. In view of large amounts and increasing importance of transfers through the Finance Commission, it is important that these allocations are viewed in the total perspective of resource availability and requirements for development. The task of looking after the development needs of different States cannot be left to the Planning Commission alone, when it is handling only about one-third of the total resource transfers. The Finance Commission, therefore, should give more than the marginal importance it has hitherto given to question of over-all development in the different regions of the country. It

is possible only when the total amount of resources to be transferred by the Commission are looked in their entirety as well as in combination with other source of States' income, and some set of criteria based on the needs of the States arising out of national priorities of development, are applied in devolution of different taxes and grants (except, of course, in cases where some constraints are explicitly provided on such uniform application of the criterion, e.g. with regard to the distribution of additional excise duties and grant on account of wealth tax on agricultural property).

It is obvious that the application of the criteria of developmental needs of the States to the entire pool of resources to be distributed, will make the Commission a more effective mechanism for correcting inter-regional imbalances than hitherto. As a matter of fact, the issue of inter-regional balance has appeared specifically and explicitly in the Commissions' recommendations, only in the determination of the part of the grants-in-aid under Article 275, and in the case of distribution of the part of the Union excise duties. In the former case, the Sixth Finance Commission, for example, worked out the requirements of the States backward in standards of general administration for upgrading these services to bring

them to the national average. The services considered are general administration, administration of justice, jails, police, primary education, medical and public health, and welfare of scheduled caste, scheduled tribes and backward classes and deficiency is measured in terms of the shortfall from national average per capita expenditure on these services. The estimates are then added to the non-Plan revenue deficits of the States with a view to determining grants-in-aid under Article 275 of the Constitution. In the case of distribution of Union excise duties among States, 'distance' of States' per capita income from the national figure has been made the basis of allocation for 25 per cent of the divisible pool, the rest to be distributed on the basis of population. Population has always figured as predominant criterion in the allocation of net proceeds of the shared taxes among States, particularly of the income tax, union excise duties, additional excise duties, and estate duty on movable property while collection or tax base has been applied partly in the case of income tax, and additional excise duties and fully in the case of grants-in-aid in lieu of railway passenger tax, estate duty on immovable property, and grant on account of wealth tax on agricultural property.

It appears, therefore, that the correction of regional imbalances have only marginally featured as a principle in the Finance Commissions' deliberations and recommendations. Collection base is a criterion which contributes to the perpetuation rather than correction of disparities; and, does not seem to have any major force of argument behind it except the bargaining position of States with larger contribution to the tax; it amounts to some reward to better off States and punishment to States with low tax base. Population is again a basis which can at best prevent increase in disparities. The expenditure-receipt gap provides a static criterion and seems more of a philanthropic gesture than a rational criterion for a positive approach towards development of backward States. The Sixth Finance Commission's approach in case of part of grants under Article 275 for upgradation of administration may be considered a step in right direction in this context. But its applicability was confined only to that item and, therefore, had a limited impact. A criterion like population share of a State weighted by relative distance of States' per capita income from that of the State with highest per capita income, made applicable to the larger part of the devolution of resources by the Finance Commission, particularly, in the distri-

bution of net proceeds of taxes, may prove more effective in the direction of reducing disparities in the levels of living and development among different States.

Per capita income, although favoured for its convenience and presumed capacity to encompass most of the manifestations of levels of development, has obvious limitations as the sole criterion for any type of policy-making. Of late, therefore, structural aspects such as distribution of income and certain direct forms and causes of backwardness and development have been increasingly emphasised both for analysis of problems of development and policy making. If the devolution of resources by Finance Commission is to contribute towards implementation of the development strategy and policies, which, it is argued, it should, then the Commission will have to evolve multiple criteria to take account of the scheme of priorities accepted by the nation. In the context of the present development policies, it would be appropriate for the Finance Commission to take into account such factors as extent of poverty, unemployment, and illiteracy, to work out the needs of different States for financial resources, particularly in determining the grants-in-aid under Article 275. The financial requirements of efforts needed in the States to bring about a reduction

in these indicators of backwardness over a period of time could be assessed and the shares of States determined on that basis.

Obviously the allocation of resources by the Finance Commission itself will not achieve the avowed objectives, as the resources handled by the Commission form only a part of the total resources being allocated through various channels. But it can certainly contribute towards the goal by giving greater recognition to the scheme of development priorities than given hitherto. The Commission may first assess the total resources available with the Centre for transfer to States by way of grants-in-aid and allocate them among different heads according to the priorities in the national economic policy. For example, if eradication of poverty, unemployment and illiteracy are accorded priorities in that order, say 45, 35 and 20 per cent of the available funds for grants-in-aid may be fixed for these heads, and the funds so allotted for each of them may then be allocated among States on the basis of number of people below the poverty line, number of unemployed and number of illiterate people and/or number of children in the school-going age group respectively.

The approach suggested in the above paragraphs would, of course, mean a major break from the past. It may even be argued that the transfer of resources through Finance Commission is primarily a device to buttress the disequilibrium that inevitably arises between the division of functions and resources between the Union and its constituents in a federal set up, and it is not suited for the purpose of subserving the objectives of development planning. The argument is relevant for a static situation and for an economy where the State does not intervene in a positive and major way in the process of development. In an economy being run primarily on the basis of planning by the government, the financial operations and transfers have to be seen not merely as fiscal tools of matching resources with expenditure but a part of the development finance. The past Finance Commissions recognised the need for such an 3153
approach, but were content with making marginal changes in the relative ~~from~~ weights to the criteria laid down mostly by the first Finance Commission, without seriously attempting to radically change the pattern of devolution in line with this approach. One hopes that it will be possible for the Sevehth Finance Commission to adopt the less convenient procedure of having a fresh look at the objectives and criteria of the entire scheme of devolution.